THE FUNCTIONS OF A BANK IN RELATION TO THE CAPITAL MARKET

by

F. W. HOOPER

A discussion of some criticisms of the London Capital Market in its relations with British industry, and of a suggested line of remedial action by the joint stock banks.

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Professor of Economics
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FOREWORD

BEING partly responsible for the publication of this essay I welcome the opportunity of writing a short introduction The author who is engaged in banking wrote the essay for the purpose of giving precision to his own views When I read it, in manuscript I felt not only that the subject was important and topical but also that many others would welcome an opportunity of reading so clear and concise a statement of the issues that it raises and of examining the constructive proposal submitted by the author I therefore persuaded him to publish the essay

The net effect of the financial crisis of 1931 has been to enhance rather than injure the prestige of this country The British banking system is still admired—indeed envied—in other countries not least in the United States of America Among recent achievements it has enabled other financial institutions to bear the strain imposed by the Central European crisis that preceded our own crisis But the financial system is neither complete nor perfect within its present sphere Post-war experience has revealed one important defect the machinery for providing long-term capital for industries that are still developing is seriously inadequate

During the past three years the available supply of capital has exceeded the effective demand to an embarrassing extent Deposits in trustee savings banks and in post office savings departments, together with invest-

ments in national savings certificates, have brought large sums annually within the control of the Government, which is under obligation to pay rates of interest far exceeding the current rate at which it can obtain short-term loans Building societies receive (or are offered) money from depositors and shareholders on a scale far greater than the scale of demands of borrowers Joint-stock banks accumulate deposits more rapidly than is needed to meet the requirements of approved borrowers

The failure of economic society to utilise current savings fully is due to a combination of circumstances But there must be a considerable latent demand for investment capital among those who cannot make use of the existing machinery I refer not to the demands of large organisations in "rationalised" industries, which are provided for in the existing system, but to the numerous small demands of new or relatively small business enterprises in which development is retarded by lack of capital

The creation of a National Investment Board has been advocated, partly to meet this need Mr Hooper submits an alternative proposal Whether readers accept or reject that proposal they will at least agree that the problem examined by the author is both important and urgent, and that the value of this book is not to be measured by its length

J Harry Jones

University of Leeds,
January, 1936

AUTHOR'S NOTE

The writer feels he must at once warn the economic student that, in presenting this very small work on a very large subject, he does not pretend to offer him a treatise possessing the slightest commercial utility The text-book value of this essay must, indeed, be almost negligible, for he lays no claim to any first-hand experience of the higher finance But, lest the reader should wish to credit him with a becoming modesty, he hastens to declare his opinion that, for an imaginative exercise in applied economics—which is really what he has to offer—such experience is not altogether indispensable, so long as the *reported* experience, which must serve most of us for knowledge, be sufficient, reliable and carefully digested The expert will form his own conclusions about the degree in which the writer's knowledge satisfies those requirements The writer will, indeed, value very highly any criticism or suggestion the expert is generous enough to offer him out of the rich store of his experience Unfortunately the vested interest of the practitioner often inhibits him from the contemplation of his craft in that detached scientific spirit which is assumed so easily by the presumptuous and irresponsible amateur Yet that spirit inspiring the highly skilled banker or financier lifts him into the company of the lordly ones of a worthy craft The scientific spirit is probably the most precious thing in the modern world and there seems to be plenty of room for it in the important little world of the City of London There is no reason why the financial organisation should be a mystery which it is almost indecent to discuss openly yet there exists at present no authoritative detailed account of the working of such an important part of that organisation as the London capital market! The writer

will venture the opinion that there is considerable need for such a work, but it will not be forthcoming while we continue to regard finance as an "art" (meaning that we prefer to tell practically nothing about it) He cannot of course, claim to have made any serious scientific contribution to the subject in this little book It will, however, fulfil its purpose if it provokes reflection and criticism among students or those involved, in however modest a way, in the running of some part of the great financial machine That purpose must provide his excuse for stepping in where the angels have feared to tread

January 1936

NOTE *The author is indebted to the Controller of H M Stationery Office for permission to reproduce various extracts from the Report of the Committee on Finance and Industry, 1931 (Cmd 3897)*

I

The Domestic Capital Market—Delimitation of the Region of Inquiry

(1) In every advanced economic system organisation of the exchange of its principal commodities in markets is characteristic The functions of the market are two-fold it serves as a common rallying point for available supply and effective demand and fixes a price at which these forces are brought into equilibrium The capital market—the term is used in its broadest sense—exercises the same functions as any other market, and in common with any other market can be considered either as the organisation of supply to meet the demand or as the means whereby demand is adjusted to the supply While neither view of the market can ignore the opposite view it is possible to concentrate examination upon one side or the other, and in this essay it is to the side of *supply* that inquiry will be directed

(2) The English capital market embraces in a single term a great variety of agents for the supply of capital operating throughout the entire field of the country's industry It is, therefore, the more necessary to preface this inquiry by delimiting in that immense field the particular narrow area with which we shall be concerned while at the same time defining as far as possible the position of the part within the whole But before quitting the brief statement of theoretical premise necessary for a sound approach to more practical considerations it may be advisable to describe very shortly the peculiar functions of the capital market as a whole They have been well summarised by Lavington * "All the complex and

* *The English Capital Market*, 1921

highly specialised processes which form the organisation of the market are tributary to two functions, they are an elaboration of two elementary services the first is that of supplying a stock of money, the second is that of facilitating the transfer of capital"

(3) The sources of capital for the extension of business and industry are many and various and not all of them, perhaps, could be considered as falling within the widest view of the capital market It may, however, be said that there is at all times a total demand by *entrepreneurs* for new capital and a total supply of capital—or spare money—awaiting investment, and all the "complex and specialised processes" which serve to bring together and into equilibrium the effective demand of the *entrepreneurs* and the resources of the capitalists available for investment must be included in the capital market

(4) In the first part of the nineteenth century, when the industrial unit was, as a rule, the family concern, "permanent" capital was provided privately, by inheritance, partnership or private contract, and was generally further built up out of accumulated profits The existence of a comparatively large wealthy class and a willingness among the wealthy to invest their savings were among the exceptional and favourable conditions attending the rapid growth of British industry in the last century It will be important to remember that the first condition at least, was peculiar to this country and in fact, differentiates our early industrial development from that of any other country

(5) Despite the invention of the limited-liability company and the more recent growth of large-scale industry the method of obtaining capital by private negotiation has persisted for various reasons, and to this day is of

such importance as is perhaps not generally realised Even the majority of joint-stock companies are private limited companies which either possess their own capital or procure it locally often from business associates or through the agency of solicitors This wide section of the capital market in which solicitors brokers and other private agents are at work would be exceedingly difficult to investigate and is in any case outside the scope of this inquiry but it is well to recognise at once its importance in order the more clearly to define the particular region of the capital market with which we are concerned

(6) That region falls within the section of the market which formulates the demand for capital in *new Stock Exchange securities*, a section which however serves not only domestic needs but also the demands of overseas governments, municipalities and corporations which, again are outside our terms of reference It is therefore, fortunate that in the actual structure of the new-issue market there has always been a fairly sharp division between domestic and overseas issues facilitating exclusion of the latter when home investment especially is under consideration We are thus in a position to define with moderate accuracy the location of the problem to be investigated since it is *incident to that region of the domestic capital market wherein demand is given effective form as a Stock Exchange security*

II

Examination of some Criticisms of the City of London

(7) It is self-evident that this region is virtually co-extensive with the "City," within whose unsubstantial boundaries is concentrated the large assembly of financial concerns engaged partially or exclusively in the issue of new securities. Varying greatly in resources and reputation from the great merchant-banking houses down to a host of ephemeral *ad hoc* promoting groups, and further diversified by specialisation in one or another class of security, these issuing agencies form that extremely loosely knit organisation which is vaguely known as the London capital market. While it is not the purpose of this study to venture upon a thorough exploration of what is undoubtedly, for the outsider, the least charted territory of the whole realm of finance, it is quite admissible to put the London capital market to the test of general conclusions as to the essential functions of a capital market and, in particular, to examine the views of responsible critics on the efficiency with which it discharges those functions in relation to British industry. For by that convenient term *domestic capital market*—with its penumbra of abstruse economic theory and its power of suggesting vague notions about the obscurer practices of the financial world—is generally and quite rightly understood a fundamentally simple process: that of the supply of long-period capital to British industrial companies.

(8) The upheaval, precipitated by the war, of our industry and commerce and the maladjustments of the post-war years with their appalling consequences to

employment and industry, indirectly served at least one good purpose They gradually compelled intelligent citizens to inquire more insistently than ever before into the rationale of our financial system, and, not unnaturally in the stress of accumulating difficulty and hardship to season inquiry with some outspoken criticism of institutions which had previously been considered immune from all but the most expert comment This popular invasion of a field of which the specialist had hitherto been in undisputed possession was not without its repercussions in high quarters Popular clamour, even if sometimes strident and ill-informed found an echo among sober and responsible critics There was a widespread demand for information about the whole monetary machine, yet no compendium of authoritative information existed to satisfy that demand The technical nature of financial problems made lay criticism of doubtful value yet the time seemed to have arrived when an intelligent public opinion on financial matters was desirable not only in the national interest but also in the " enlightened self-interest " of what is sometimes known as the financial hierarchy " (a derisive description implying the existence of an exclusive and secret cult!) There appeared to the Government to be a good case for an official inquiry not only to allay public misgivings and supply a kind of authorised version of monetary theory for public use but also to indicate what steps might be recommended to the financial world itself to enable it to play a more conscious part in promoting the recovery of trade commerce and employment The Chancellor of the Exchequer therefore appointed by Treasury Minute dated 5th November 1929 a Committee on Finance and Industry instructing it 'to inquire into banking finance and credit, paying regard to the factors both internal and international which govern their operation and to make recommendations calculated to enable these agencies to promote the development of

trade and commerce and the employment of labour" The Committee's report, now famous as the Macmillan Report, was published in June 1931

(9) This is not the place in which to discuss the Committee's findings at length, since they cover the whole monetary and financial system, in which the domestic capital market—or, as the Report styles it, the capital market for home investment—is but one important factor It may, nevertheless, be said that the Report will probably remain the most brilliantly lucid summary available of banking, finance and credit as they existed and functioned in Great Britain prior to September 1931 Unfortunately the crisis of that month, following close upon the Report, considerably diminished public interest in the latter, though it is difficult to comment adequately upon the statesman who hastened to announce that the Macmillan Report was as good as dead One can only conclude that he had not had time to read it, and imagined that it began and ended with the gold standard

(10) There is no question that the chapter of the Report dealing with recommendations affecting the domestic capital market is as worthy of attention to-day as it was in 1931 It is therefcre proposed to examine in some detail the practical possibilities of the Committee's recommendations, which, owing no doubt to the special restrictions imposed by the abandonment of the gold standard (despite the relief which it afforded temporarily) and the War Loan conversion, possibly suffered a little from the enforced preoccupation of the City with other problems of an exceptional character Before dealing with the recommendations, it will be as well to recapitulate the general criticisms of the capital market which the Committee took into consideration They are already too well known to those who are familiar with the Report to need emphasis,

and its most critical readers would probably admit that its admirably moderate tone is never employed to better purpose than when expressing its views upon these criticisms (*vide* Part 2, Ch 4) and making broad suggestions to promote the greater efficiency of the market in its relations with industry

(11) In the first place, the Committee drew attention to the peculiar characteristics of the London money market, which for very good reasons had never established any very close contact with British industry as a whole The reasons were primarily historical in their nature, the money market was a highly developed adjunct of London s international trade and commerce long before industry began its rapid growth in the nineteenth century In paragraphs 4 and 5 allusion has already been made to the well-known method by which that industry was financed—from private sources and out of profits—a method which suited the small-scale businesses of the time well enough Its drawbacks, however, soon appear as the size of the industrial unit increases Capital requirements gradually increase until the modern unit, probably representing the progressive amalgamation and absorption of a number of older and smaller units demands the investment of perhaps several millions of capital for further development, instead of the thousands or tens of thousands of a century ago The sturdily independent manufacturer of those days provided his own capital, or else knew where he could obtain it privately and locally The modern *entrepreneur* can of course no longer look to such sources for the comparatively enormous capital his undertaking may require He is generally obliged to look to the capital market, one of whose functions we have noted, is to supply a reservoir of money available for investment When industry reaches a stage at which it must have large aggregations of capital to finance it the efficiency of the capital market in dis-

charging its functions of organising the supply and facilitating the transfer of capital becomes a factor of vital importance to the industry of the country

(12) As to the efficiency of the London money market for many purposes there is no question at all The Report recognises in the City of London "the most highly organised international market for money in the world Its freedom and elasticity are without parallel Its accepting houses and its discount market provide unequalled facilities for the financing of national and international commerce, whilst the former, in their capacity as issuing houses, play a large part in the placing of international issues of a long-term character Lastly, the great British joint stock banks have the pre-eminent merit that their financial strength and liquidity are beyond question It is noteworthy, however, that, speaking generally, the exceptional merits of the City of London lie in the facilities given by the short-term money market for the employment of home or foreign funds, in the financing of trade and commerce, also both home and foreign, and in the issue of foreign bonds as distinguished from the financing of British industry" (paragraphs 375-6)

(13) This traditional preoccupation of the money market with short-term and international finance has been reinforced by the traditional independence of industry of financial control (both rooted, it must be reiterated, in their historical development) to produce a kind of estrangement between the two, or rather to retard the development of their co-operation when this became an essential condition of a healthy and rapidly growing industry That, at least is the conclusion implied quite clearly in the Report, and that the facilities given by the City for the financing of British industry cannot be counted among its many exceptional merits is of course an obvious

corollary Some attention must therefore be given to the arguments which can be adduced in its support

(14) In the first place, we may note the great superiority in respect of financial resources, market reputation and the ability of their very names to command public confidence in a security of those agencies which have specialised in the issue of foreign government loans as compared with the various agencies, generally unknown by name to the ordinary investor, which sponsor the ordinary home industrials The former class comprises the great merchant-banking houses a few famous names like Rothschild, Schroder, Seligman Such firms by reason of their highly developed acceptance business requiring the closest relations with connections in foreign countries were at one time practically the only agents able to transfer the large sums involved in foreign government borrowings , and the firm which could transfer the capital was obviously in a position to secure the business of issuing the bonds Possessing these advantages, these houses built up a reputation for the highest integrity which was indeed essential to their business, for in the money market the mere reputation attaching to a name is often the truest security, but which to the ordinary investor meant that when one of them invited public subscriptions to a foreign government loan it really did vouch for the security, in so far as it had protected and would continue to watch over the interests of subscribers as far as was humanly possible To this end it must therefore maintain reliable agents in the borrowing country to keep it informed of the country s financial condition agents through whom it might also give advice if required or convey a protest in the event of the borrower taking any action prejudicial to the security of the loan or otherwise adverse to the interests of investors In short the obligations undertaken by the issuing house involved continuous

contact with the borrower and a continuous study of his financial condition If, after such scrupulous supervision, anything were to go wrong with the loan, the issuing house could hardly be blamed, moreover, investors would generally be kept informed that every possible channel was being exploited by the issuing house on their behalf There is little sign of any blame having been imputed to the issuing house for recent happenings, for instance, in Central and South America It is generally recognised that no legal security can of itself fully prevail against repudiation or bad faith on the part of governments, or against an overwhelming economic depression The validity of foreign investment in general is dependent upon the extreme unlikelihood of such disasters

(15) The sound organisation of the London market for foreign investment has, in fact, been generally acknowledged by authorities The writer is not in a position to expound it in any detail But enough has been said to suggest very strongly that the high *quality* of the market is due mainly to the standing and character of the issuing house To say, however, that the efficiency of a market depends largely upon the character and capabilities of the principal agents operating in it is merely to state a truism If the foregoing brief description is to serve any purpose it must lend support to the contrast which critics have observed in the organisation of the domestic capital market

(16) The Macmillan Report notes the existence of one or two first-class houses in the City which perform for certain first-class companies the same functions as the older issuing houses perform for foreign borrowers", municipalities, railways and a few first-class joint stock companies may issue their own securities, and save the expense of an intermediary, while, in a few recent

instances, the banks are known to have assisted in the financing of new capital issues for some important British companies in the heavy industries When this has been said, the outstanding fact remains that the majority of new industrial securities in a period of normal activity—the proportion becomes overwhelming in a boom period—are issued by concerns whose names mean practically nothing to the ordinary man

(17) Among these concerns there is in London a small group of finance companies which specialise in issuing business and have a reputation in financial circles which they could not afford to lose by undertaking worthless promotions But below this respectable class of issuing agents there are innumerable minor companies and groups, some formed for but a single promotion and most of them having little or no reputation to lose It is in this class that underwriting and other promotion scandals appear during a speculative boom, when the public is in its most gullible mood The Macmillan Report gives some staggering figures for the year 1928 which are worth quoting (paragraph 386)

" In that year the total amount subscribed for capital issues whether of shares or debentures, of 284 companies was £117,000,000 At 31st May 1931 the total market value of these issues as far as ascertainable was £66 000,000 showing a loss of over £50,000,000 or about 47 per cent In fact the public's loss has been greater since many of these shares were no doubt, sold by the promoters at a high premium Still more striking perhaps, 70 of the above companies have already been wound up and the capital of 36 others has no ascertainable value The issues of these 106 companies during that year amounted to nearly £20 000 000 "

After making the most generous allowance for the effects of trade depression there clearly remains a good deal to

be accounted for, and it will be helpful to the main purpose of this inquiry to examine the various ways in which the present machinery and structure of the domestic capital market may have contributed to that waste of capital

(18) In paragraphs 11-13 reasons have been given for the estrangement or lack of co-operation between industry and the capital market upon which it is becoming increasingly dependent It is not that there is any lack of sympathy or goodwill towards industry, but that the finest institutions of the capital market, the old-established private bankers of world-wide reputation, appear to have been largely precluded by specialisation in first-class foreign issues and the need for liquidity imposed by their great acceptance business from participation in the domestic capital market * The result has been to leave this field to an indefinite number of relatively irresponsible finance companies, "trusts," and groups which, whatever their merits, would certainly not undertake to assume the same kind of obligations towards their securities as we have briefly alluded to in paragraph 14 It was stated that the only object of that paragraph was to lend point to a contrast, and it is believed that this will appear more striking when we have considered certain features of the domestic capital market in their relation to the elementary principles stated in paragraphs 1-3

(19) It has been said that the facilitating of the transfer of capital is an essential function of the capital market Nothing has so far been said of the direction in which it should be transferred Yet in an industrial system characterised by an immense variety of products, the

* Signs are not, however, lacking that the serious diminution in their acceptance business is urging these institutions in an increasing degree towards experiment in the financing of domestic enterprise

importance of the proper direction of new capital which however plentiful must be limited in the total amount is clearly of first importance This need not lead us into political or social considerations This inquiry must assume that the proper direction of capital is toward those points where the yield of net interest is highest disregarding indirect social effects [*] The determination of those points involves most careful estimates of prospective earning power

(20) It is now becoming widely recognised that it is or should be the business of the market to supply the well-informed opinion which is necessary for such an estimate The limitations of the ordinary investor's ability to estimate the prospects earning power and risks of almost any new security which may be offered to him by public prospectus are sufficiently evident He probably knows very little of the industry in general or of the products of the particular company and almost nothing of the special risks attaching to its operations He only knows that some risk is inseparable from any venture and in any particular case assesses the risk according to his temperament his idea of market opinion or probably at best his stockbroker's advice If he feels in a very speculative mood he may ignore risk altogether this must indeed be a widespread attitude during an investment boom In any case the inexpert investor faced with a somewhat speculative proposition can find little or no reliable guidance The published prospectus may be a sober statement of facts or may include a good deal of special pleading on behalf of the company If he turns for guidance to the financial columns of his newspaper he will find no reference at all to the issue or else a very guarded

[*] This is the definition made by Lavington (*The English Capital Market*) of what he calls the "true social need" for capital, as distinct from the "actual demand" It appears to be valid for the present argument

reference which may sometimes amount to no more than a quotation lifted from the more harmless part of the prospectus City Editors are said to be often restrained from any outspoken comment on a prospectus by their respect for the law of libel and for the revenue derived from their financial advertisers

(21) The investor might feel that his interests were being protected as far as possible if he could see in the prospectus the name of an issuing institution of undoubted reputation which, before making the issue, had undertaken (he knew) a thorough investigation of the company's prospects and earning power in the light of a close acquaintance with the industry in which the company was engaged, and which was more or less engaging its reputation that the issue was in general as sound as could be expected What he actually does see, close to the name of the company itself, is the name of one or more of the great banks, which may even appear to be fathering the issue This, of course, is practically never true, and it is doubtful whether many investors are in fact misled in this respect as easily as the Macmillan Committee apparently believed The fact remains that the ordinary investor probably does not recognise, or in any case pays no attention to, the name of the real issuing concern, which usually appears inconspicuously among the names of brokers, solicitors, accountants, valuers and anyone else more or less connected with the principal company for purposes of the issue, or in the list of "material contracts"

(22) It is proposed in a later paragraph to touch upon a few of the criticisms which have been made of the domestic capital market on what may be called technical grounds Here it is sufficient to show that, in general contrast to the foreign investment market, the name of the issuing agent is generally unknown to the public, and carries with it

little or no guarantee implicit or otherwise that the enterprise is one with a reasonable claim to the capital for which it asks Moreover, the interest of the issuing agent in the company is often limited to the particular issue of capital and ceases once the capital has been subscribed * the underwriting commissions have been paid and the conditions fulfilled which are imposed by the Committee of the Stock Exchange before it will grant permission to deal in the security

(23) It may be argued that this system has the advantages of every *laissez-faire* system The business of issuing new securities is so specialised that only a concern well versed in all its intricacies is competent to undertake it For instance, if the issue is underwritten as it nearly always is, the issuing concern is usually the main underwriter It is usually partly responsible for the prospectus and arranges all the preliminary publicity It is in touch with the market in a way which is hardly open to the directors of the principal company and is thus in a favourable position to advise on many of the important technical points connected with the issue It is not necessary for the issuing concern to be in continuous touch with the industry or even with the particular company Its function is to arrange that the required capital shall be forthcoming It acts simply as a middleman between the investing public and the company It knows "the ropes" in its special sphere and that is all the public or the company can expect It cannot be held responsible if the company should subsequently fail, its business is to see that the *issue* succeeds The investor is a free agent and, especially in England, prefers to use his independent

* This is not always so The issuing agents may be paid for their services by the allotment of shares and may be empowered to appoint a director But where the issuing agents have no reputation with the public, their participation in the enterprise cannot be said to have any value as a warranty to the public

judgment as to what he shall invest in, while anything in the nature of continuous financial investigation and supervision is impracticable, or would be intolerable to industry

(24) It is indeed true that the London capital market comprises a number of highly specialised agents This appears to be a distinguishing characteristic of the City as a whole, and no doubt contributes towards the efficiency and especially the elasticity of the financial organisation Specialisation works particularly well in the money market where it is accompanied by a sufficiently close integration of functions imposed by the controlling policy of the Bank of England and reinforced by a large degree of voluntary co-operation between the members of the market At the same time the control by the London joint stock banks of a complete branch-banking system ensures that industry throughout the country is continuously in close touch with a uniform credit system Thus the liaison between industry and the money market may be said to approach perfection, the mechanism at least is complete

(25) The liaison, however, between industry and the capital market is not so complete, very largely because the necessary mechanism has not reached a comparable state of development There are two reasons for this first, a comparative lack of *co-ordination* in the structure of the market itself (which in the money market accompanies the high degree of specialisation), and, second, the relatively inferior *status* of the great majority of the issuing agents (the absence of issuing institutions comparable in public reputation to our banks or acceptance houses)

(26) The results of an imperfect liaison between industry and the capital market would naturally tend

to be, in a period of great public confidence, a boom in new issues, good, bad and indifferent, in a period of depression, a drying-up of the stream of capital for industry by its diversion, to an exaggerated degree to the "gilt-edged" and the short-term markets Under boom conditions innumerable issuing companies and promoting groups suddenly arise to take advantage of the glorious opportunities presented by the public gullibility, and capital is thus misdirected into scores of hopeless concerns with such tragic results as are shown by the figures for 1928 already quoted from the Macmillan Report The question whether such a state of affairs might be avoided if the investing public were in the habit of looking for the name of some responsible well-known issuing institution in the prospectus of every industrial issue is perhaps worthy of consideration It may not be possible, under a system of free enterprise, to prevent entirely the exploitation by unscrupulous promoters of the inexperienced investor infected with the gambling fever But there seems good reason for supposing that if the domestic capital market were to some extent "rationalised," as it might be if some of our strongest financial institutions were to enter this field the worst effects of an investment boom might be avoided The legislative protection of the Companies Acts and the rules of the London Stock Exchange* aim at the prevention of abuses by making them technically impossible, but they can hardly touch the economic problem which is to show what conditions in the market will tend to secure the allocation of new capital to those enterprises which impartial investigation shows to be worthy and to prevent the wasting of capital upon enterprises which impartial investigation might have shown to be unworthy, all this, without producing conditions which might tend to stifle new enterprises of a

* *Vide* Rules and Regulations of the Stock Exchange, 1931, Appendix 34 Regulations for obtaining permission to deal in New Issues

pioneer character or to impair the freedom of choice of the private investor who supplies the capital

(27) Despite the more spectacular losses which have been suffered in the past by investors and by industry in periods of abnormal activity in the capital market, it is probable that industry suffers no less in a period of stagnation, by starvation of the capital necessary for reorganisation and development The post-war depression in the basic exporting industries of this country has compelled them to seek drastic reductions in costs to enable them to continue to meet powerful foreign competitors on more or less level terms This common pressure of circumstances has almost demolished the old independence of action which our manufacturers had long maintained as a dearly prized tradition, and has forced upon many sections of industry the recognition of a common cause in the imperious necessity to reduce costs, not only by wage-cutting, proved to be but a half-solution, but also by improving efficiency It is needless to labour this point at length for, broadly speaking, the need for reorganisation of the basic industries is accepted by industrialists and economists alike

(28) The movement of industry since the war in the direction of large-scale amalgamations, a movement which was in being before the war, has therefore been accelerated Many schemes, however, have been hindered in recent years by the financial crisis and a general uncertainty in all circles concerning our industrial future The Macmillan Committee therefore made a strong plea in their report for a closer understanding between the powerful financial and banking institutions in the City and the depressed basic industries The paragraph* in question is a condensation into a few sentences of the thesis that,

* Para 385

since the problems attending amalgamations and reconstructions are largely financial their solution should be sought in the closest co-operation between the leaders of industry and the leading banking and financial institutions This implies a readiness among industrialists to face with courage the tremendous changes which are taking place in methods of production and a readiness in the City to study more closely and sympathetically than hitherto the peculiar problems confronting each industry until our great financial institutions as a whole can claim to possess exhaustive information upon the financial condition of every important industry and of every important business unit within the industry This new function would no doubt, demand the creation of large economic research departments , and the possibilities of this idea—indeed, its fundamental importance—will be somewhat enlarged upon in a later section For the present it may however, be suggested that the assimilation into the ordinary practice of British banking of functions originally no more than advisory in their nature might eventually compel the banks to undertake obligations of a more onerous kind A business man does not generally go to his bank for pure advice , he can get that from his accountant or solicitor From his bank he expects not only practical advice, but a willingness towards practical co-operation , so in the larger relations between the banks and industry, it seems improbable that economic advisory departments attached to the banks would be really effective unless they were part of an organisation for more active co-operation with industry, which, in the present context, means some form of participation in the raising of the capital necessary to finance agreed schemes of reorganisation

(29) There are admittedly, precedents for this latter departure The Bank of England, the joint stock banks

and the private banks have in a few known cases,* and probably in others which have not come to light, given financial assistance of one kind or another to important rationalisation and reconstruction schemes in the iron and steel, engineering and cotton industries While there is no purpose to be served by quoting these cases in any detail, their very existence shows that to some extent it has been found possible for British banks to assist in the provision of investment capital, as distinct from temporary advances, for British industry It is very doubtful, however, whether such isolated cases indicate any real change of attitude on the part of the banks towards industrial financing Probably in every case which could be cited there would be found special reasons which compelled the bank to adopt a course alien to the accepted principles of banking in this country A special urgency in the situation of a customer or of a concern of some national importance rather than "a close and continuous relationship with the industry concerned" would perhaps supply the motive This, however, must necessarily be little more than conjecture The point which may, however, be usefully made is that the capital market, as at present constituted, has little use for "depressed" industries, and their regeneration, in which financial reconstruction must play a critical part, may be very seriously retarded by the consequent difficulty, even impossibility, of obtaining the necessary capital That the banks should in a few very important cases have come to the rescue should be taken as evidence, not of any permanent change in banking policy, but of the inability of the ordinary agents in the domestic capital market to solve the peculiarly difficult financial problems of an industrial depression Something altogether bigger than the majority of existing finance companies and promoting groups is clearly re-

* These can be found in *British Banks and the Finance of Industry* (S E Thomas)

quired to carry through the big financial operations which must be involved in large-scale reorganisations which may even embrace an entire branch of an industry with all its interlocking interests its redundant factories and plant which must be scrapped its complex international ramifications and perhaps, its strategic importance for the State The financial institution which can deal in the ordinary course of its business with the issuing of new securities on a correspondingly large scale should have the standing and resources commensurate with its great responsibilities, whether it acts alone or in association with other similar institutions It should also be an integral part of the financial system as a whole, serving as a liaison between that system and the industrial world

(30) Such is the burden of the criticism of the City of London in the role of "guide, philosopher and friend" to industry which a few economists and financial publicists have been creating for it since the war The Macmillan Committee, moreover, has lent the support of its great authority to this school of thought, which may be said to be characterised broadly by the view that the joint stock banks, by entering the field of "investment banking" (a useful American term), should remedy the worst deficiencies of the domestic capital market

(31) Before proceeding further we may now summarise the various criticisms which have been examined

(i) *A traditional lack of co-ordination between the financial organisation and industry* due largely to the following historical causes —

(a) the early development of the City of London as a centre of international commerce (with the money market as a clearing-house for international indebtedness and a reservoir for short-term funds)

(*b*) the foundation of British industry on the family concern, supplying its own capital and supplementing it from local sources ;

(*c*) the financing of joint stock enterprise by a large wealthy class of independent investors ;

(ii) arising out of (*a*) above, *the superior organisation, in the private banking houses of the City, of the means of supplying capital to foreign countries*, as compared with the haphazard character of the market for home investment, which was left in the hands of private individuals and minor concerns of relatively small repute ;

(iii) *home investments do not, therefore, carry with them the implied warranty of a responsible issuing house*, except in rare cases, with the result that the investor usually has to rely upon an inadequate knowledge of the risks and a more or less unreliable estimate of the prospects of these investments ;

(iv) for the same reason there is *no close and continuous association between important industrial companies and the capital market* through the agency of first-class financial institutions, with expert knowledge of industrial conditions and able to give advice on all matters relating to finance, besides arranging the issue of new securities ;

(v) as a result of the *general lack of co-ordination between the domestic capital market and industry, and between the capital market and the banking system*, capital may be partially misapplied and wasted during an investment boom ; while under reverse conditions industry may find great difficulty in obtaining fresh capital for justifiable and necessary developments

III

The Recommendations of the Macmillan Committee

(32) The recommendations concerning the relations between finance and industry and in particular the provision of long-dated capital for industry, are contained in paragraphs 397 to 404 of the Report After expressing agreement with the view that "the British financial organisation concentrated in the City of London might with advantage be more closely co-ordinated with British industry, particularly large-scale industry, than is now the case," and alluding to the strong tradition of individualism in industry and the prevailing views as to the proper sphere of banking in this country, the Report suggests that "nevertheless a further development of our financial organisation is possible, which would be distinctly beneficial and need not be inconsistent with these traditions"

(33) The Report then postulates with considerable emphasis a healthy position in British industry as a whole as an essential condition of any reform in the capital market The reason is a practical one ' No institution acting as an intermediary between industry and the investor can possibly succeed unless the securities which it induces the latter to buy prove to be sound and remunerative" This condition, though apparently obvious, is so important that it may well be re-stated in a somewhat expanded form It is equivalent to asserting that the *reputation* of the issuing institution—which should be in itself a sufficient assurance for the average investor that a given undertaking has a reasonable claim to the capital

for which it asks—must largely depend on the progress of the concerns which it is instrumental in financing, in other words, on the general reliability of its estimates of business prospects While, however, forecasting in the commercial or economic sphere is never likely to be free from error, it would be altogether impossible to make any reliable estimates in the midst of economic crisis or uncertainty about the international situation or the social and economic policies of Governments Indeed, investment as a whole is primarily the expression of a faith in the future of industry and the social structure, and if future developments are destined to be, not continuous and progressive, but catastrophic and disastrous, then all talk of improving the capital market—a mere part of the machinery of a vanishing order—is a waste of energy

(34) The Report recommends the establishment of new institutions which would have the following objects (paragraphs 399 and 400 quoted in full)

> " 399 The functions which should be performed by such a concern may be summarised as follows —Acting as financial advisers to existing industrial companies, advising in particular as to the provision of permanent capital, its amounts and types, securing the underwriting of and issuing the company's securities to the public and, if necessary, assisting previously in arranging for the provision of temporary finance in anticipation of an issue, assisting in financing long contracts at home and abroad, or new developments of an existing company, or founding companies for entirely new enterprises, acting as intermediaries and financial advisers in the case of mergers or in the case of negotiations with corresponding international groups, and generally being free to carry out all types of financing business

"400 These are functions which are often difficult which entail considerable risks and which may involve the temporary locking-up of large sums

Such a concern must —

(*a*) be provided with a substantial capital where it is a case of financing large contracts for periods up to five years, it might be able to supplement its resources by the issue of its own short-term notes,

(*b*) be able to rely on the co-operation of existing institutions with large monetary resources in the making of temporary advances otherwise it might either be unable to carry out its functions or its capital might have to be too big for it to earn satisfactory dividends

(*c*) build up a competent and expert staff, establish gradual connections with industry, and instil confidence in its issuing ability and credit"

(35) It is not suggested that the banks should themselves undertake these duties but that they should co-operate in forming one or more concerns, somewhat on the lines of the Bankers Industrial Development Company with the above objects in view The Report apparently did not contemplate—it certainly does not mention—the possibility of a single bank forming its own subsidiary company

(36) The Bankers Industrial Development Company receives scant attention in the Report, which notes in passing that the authorities of the Bank of England consider the Company not to be a proper kind of subsidiary for a central bank and suggests that it should "at a convenient stage be definitely separated from the Bank of England, have an independent existence, and rely upon its profit-making capacity as a private institution It is possible that it might form a nucleus for that closer co-operation between finance and industry which we think

is required " (paragraph 403) More will have to be said about the possible significance of the Bankers Industrial Development Company when the questions raised in the last paragraph are considered

(37) The final recommendation, contained in paragraph 404, is for the establishment of another type of finance company having as its object the provision of capital for the smaller or medium-sized businesses, for which the expense of a public issue is prohibitive It is suggested that such a company in addition to its ordinary capital, might issue debentures or preference shares secured on the debentures or shares of the companies which it financed The debentures of the financing company would be dealt in in the ordinary way on the Stock Exchange, and thus the demand of the moderate-sized business for capital might be said to be given effective form as a Stock Exchange security Without a device of this kind even the soundest of such businesses are said to find great difficulty in raising in the market the comparatively modest capital they require

(38) Finally, it may be observed that the chapter of the Macmillan Report which contains these proposals has the unanimous support of the Committee, except that Sir Thomas Allen and Mr Ernest Bevin indicate (in their *Reservation to the Report*, page 241) their preference for a public corporation in place of the private institution which the Report contemplates Even Lord Bradbury, who dissented from most of the conclusions of the Report, definitely states his concurrence in its recommendations relating to the capital market for home investment This unanimity of a body of perhaps exceptionally independent-minded experts must of itself lend considerable weight to their proposals, recommending them to the serious study of everyone who may be affected It therefore becomes

the banker's duty to consider whether he is in sympathy with these proposals and if so to ask himself whether they involve such an extension of British banking as may not be incompatible with its present clearly defined functions Finally, if he can answer these questions in the affirmative he may consider the devising of machinery to make his answer effective in practice

IV

The Banker's Attitude towards the Domestic Capital Market

(39) A slight reference (paragraph 21) has already been made to the general practice of the English joint stock bank in relation to the ordinary industrial issue, whether of ordinary shares by a new company or of preference shares or debentures by an established company The bank lends its name to the issue merely as an agent for the collection of applications It may, of course, take some interest in the issue beyond that more or less mechanical operation, but it is an interest of an unofficial kind Beyond seeing that the prospectus complies with the law and that the issue is at least superficially respectable, the bank does not vouch for the issue in any way as a rule *

(40) There is, in fact, good reason why the bank should not undertake any such obligation The standing of the bank is so high that its recommendation of any new issue would alone be sufficient to ensure the success of the issue The bank's standing is, on the other hand, a tremendous responsibility to shareholders and depositors alike, and, since to sponsor the issue of an industrial company would practically be equivalent to engaging its reputation on

* The late Mr John Rae, in the course of his evidence before the Macmillan Committee, stated that his bank rejected a larger number of issues than it accepted

behalf of the company, the bank's standing might in some degree be affected by any unforeseen misfortune or adverse circumstances affecting the company or its securities In the public estimation the bank would continue to be linked, however remotely, with the company, and there would be some risk, however slight, that a fall in the value of the security recommended by the bank would react upon public goodwill This is what no bank can afford to risk, an impregnable soundness and the goodwill of the public together constitute the lifeblood of the successful bank of deposit Its very "soundness" must rest upon the confidence of every depositor in what he calls the bank's *safety* Public confidence and goodwill are thus the real foundations of deposit banking, and it is not to be wondered at that the banker will not contemplate a new departure which might in any degree diminish the strength of either As the strength of a chain is in its weakest link, so the strength of a bank exists in the goodwill and absolute confidence of its most irritable and nervous depositors

(41) While the foregoing may sufficiently explain the apparently irresponsible attitude of the banker towards the capital market, there is possibly another consideration of a less fundamental character which is nevertheless worthy of mention It arises out of the system of administration of joint stock banking, which is now centralised as far as is possible in the respective head offices of the banks This development, amply justified in theory (since the whole credit structure of the country is itself highly centralised), has been successful in practice mainly because administration has been characterised by great skill and adaptability, but at the same time it has put a very heavy burden of personal responsibility upon the shoulders of the administrators Here it may be appropriate to suggest that perhaps the truest modern English

equivalent of the word "banker" is "an administrator of a joint stock bank," beside whom the private gentleman of early banking tradition surviving in legal parlance is a person of small significance The present inquiry, for any practical interest it may have should at least begin with a realist point of view, and the choice of a point of view often lies in a choice of words If therefore, we seek the point of view of the modern banker facing the problems of the financing of industry, it may be a great assistance to consider him first as part of the administration of a great joint stock bank It then becomes clear that, already having his hands full he cannot easily contemplate the possibility of fresh departures Economists and financial experts may demonstrate the possibility of further useful extensions of his responsibilities The banker himself is anxious to institute any new service which will promote the interests of the bank and its customers, as long as it can be operated within the already wide limits (still expanding gradually) of what is generally regarded as the proper sphere of banking It becomes a different matter when proposals are urged upon him which involve a sudden enlargement of that sphere to include functions carrying with them such unfamiliar responsibilities and uncertain liabilities as would doubtless be incurred by direct participation in industrial finance

(42) Assuming the banker to be generally in favour of some development on the lines of the Macmillan Report he has to consider, then not only theoretical possibilities but also the grave question of practical expediency The field of British banking is already extremely wide it includes nowadays a multitude of subsidiary services, many of which by themselves are unprofitable, and bankers are already fully occupied with the supervision of that wide field and the many problems incidental to deposit banking and short-term finance under the difficult

conditions of the present time. This practical question may therefore present itself to the banker, who in his heart approves the recommendations of the Macmillan Committee: would the adoption of an entirely new function create additional problems, *of organisation and personnel*, so complex and numerous that, apart from other considerations, the game would hardly be worth the candle? The question cannot be answered here; for the answer must embrace too many human and personal factors. It may be hinted at by implication in later paragraphs; here it can only be suggested that in banking, as in any other sphere of enterprise, policy may possibly be finally determined by considerations of organisation and personnel rather than by decision upon principles.

(43) It is, of course, hardly likely that the banker can contemplate with equanimity the recurrence of a state of affairs similar to that which existed in the boom of 1928. The danger is too great that it might be followed by a crash like that of 1929. In those years the names of the great banks must have appeared on the prospectuses of many ventures which for one reason or another have come to a more or less discreditable end. Broadly speaking, there were two reasons for such disasters; the first arising out of what Lavington calls "distorted images of risks" in the mind of the capitalists; the second out of sharp practice on the part of some of the parties to the issue. The first cause has already been investigated, the criticisms of the domestic capital market embodied in the Macmillan Report having suggested very strongly that the issuing agency, which should be analogous to the issuing house in the overseas capital market, on the contrary possesses neither the high qualifications nor the undoubted reputation of the merchant bankers. In a system in which the issuing agent—so far from maintaining the closest relations with industry in general, and with the concerns which it

is instrumental in financing, so that its name is a sufficient guarantee of the reasonable soundness of its issues—actually remains very much in the background disclaiming as a rule any functions other than the carrying out of the issue itself the result is a lack of reliable co-ordinating factors to maintain the desirable balance between the demands of industrialists and the supply of capital available for investment Investors are therefore left to make their own more or less imperfect estimates of the prospective earning power and risks of any enterprise, with the result that they are inclined to be too credulous at the height of a boom and too nervous in the depths of a slump At both extremes there is a great waste of capital, but in the former case the losses are more spectacular

(44) The second cause embraces a variety of technical malpractices, some of them fraudulent in the strict sense of the word the remainder probably arising out of that general deterioration of the quality or morality of the market which seems to characterise the height of a boom in new issues One of the serious causes of loss in the last boom period of 1926-1928 was disclosed by a large number of underwriting defaults * It is usual for the issuing firm to act as the main underwriter of the issue, in fact, this often appears in the prospectus to be its principal function The firm out of its underwriting commission, pays all the expenses of the issue, makes the necessary arrangements regarding printing and publicity and undertakes various other important duties, up to and including the posting of allotment letters Conversely, the firm may appear in the prospectus mainly as the agent appointed to carry out all these duties including that of underwriter and being remunerated out of its underwriting commission There is practically no differ-

* Mr David Finnie has discussed these at length in his book *Capital Underwriting*

ence, except of emphasis While a study of company prospectuses will reveal many variations of detail within the limits of the statutory rules, in one respect there is usually this in common the firm which conducts the issue of the shares takes a considerable part if not all of the underwriting It is a statutory requirement that the existence of an underwriting agreement between the company and the underwriters shall be stated in the prospectus, with the rate of commission to be paid by the company This vital agreement, known as the Main Underwriting Agreement, is practically unregulated by statute, except that the rate of commission is limited to 10 per cent It is contended by Mr Finnie that the omission in the Companies Act of 1929 to regularise the form of the Main Underwriting Agreement left the way open for a continuance of the abuses which were disclosed in the last investment boom Owing to the fact that almost all issues of shares are underwritten, it is clear that the form of the agreement between company and underwriting firm is of first-class importance, for underwriting provides the guarantee, both for the company and the subscriber, that the company will obtain the capital it asks for

(45) The Main Underwriting Agreement usually permits the underwriters to "re-insure" part or all of their risk, subject to the approval of the sub-underwriters by the company's directors Since the company is not, however, a party to sub-underwriting contracts, there is no legal necessity for the disclosure of such contracts in the prospectus, which nevertheless often contains a statement (at the end of the list of material contracts which have been entered into by the company) to the effect that "various sub-underwriting contracts have been entered into, to which the company is not a party" It is natural that the investor, applying for shares in the company should take it for granted that in the event of

the applications from the public falling short of the number of shares offered the company could look to the main underwriters to make up the deficiency

(46) In practice this has not always been so Mr Finnie has shown quite clearly how the underwriting agreement has occasionally been designed to enable the main underwriters to escape from their obligations Apparently the practice is quite recent It consists in a provision being inserted in the agreement whereby the underwriters are entirely relieved of their liability to the extent that they procure applications for shares such applications including of course, those coming from sub-underwriters In this way issuing firms have been able, while figuring as underwriters, successfully to evade any liability in the event of the issue not meeting with success, the liability having been shifted on to the sub-underwriters This type of underwriting agreement led to many disasters for in a boom period when underwriting profits were attractive, very doubtful issues might be promoted by unscrupulous groups purely for the sake of making quick underwriting commissions The sub-underwriters in such a case might be mere nominees of the promoters, "men of straw" and quite unable to meet their liabilities if the issue were a failure The main underwriters were protected by the terms of their agreement with the company, and might successfully claim their commission, even if the sub-underwriters defaulted by being unable to provide for the cheques lodged with their applications The directors approval of the names of the sub-underwriters was probably only formal the former relying on the good faith of the promoters, who as main underwriters were responsible for procuring the sub-underwriters

(47) With an issue made under such auspices all would go well provided that the sub-underwriters were not called upon But in the period referred to issues of this char-

acter not infrequently failed, the companies being obliged to go into liquidation almost at once, for lack of the requisite capital The circumstances of each case might vary, but there seems to have been a fairly distinct class of scandals connected with the underwriting of capital issues revealing a source of serious weakness in the market

(48) Underwriting is clearly an essential part of the market machinery, yet the foregoing example of the kind of abuse to which it has in the past been liable illustrates only too well the lack of internal co-ordination in the market and the dangers for the whole financial system of the country inherent in a mechanism which at the height of an investment boom is so liable to get out of control No pretence will be made here to offer an account of capital underwriting It is a highly intricate and somewhat obscure subject which has already been critically explored one can readily accept Mr Finnie's thesis as far as it concerns underwriting contracts The reader may possibly wonder why consideration of such an important factor in the domestic capital market as underwriting was not included in the section in which we dealt with some of the most important criticisms of that market The reason is that we were then concerned with criticism of a system on economic grounds malpractices do not necessarily discredit an entire system, and perhaps for that reason the Macmillan Report makes no reference to events which nevertheless must have been very fresh in the minds of at least the bankers on that Committee Moreover, at the time of the preparation of the Report the Committee of the London Stock Exchange was actually revising its rules with a view to preventing future abuses in connection with new issues

(49) The Stock Exchange Committee wields an extremely effective weapon in its power to grant or withhold

permission to deal in new issues, and in its *Rules and Regulations of The Stock Exchange,* 1931 *Appendix* 34, showed a readiness to use that power in the public interest Among the many conditions attached to its permission to deal in new issues, the Committee now requires (in the case of issues by ordinary companies) that a copy of any underwriting agreement and sub-underwriting letter be lodged with the Share and Loan Department of the Stock Exchange for approval The Department may also call for a list of sub-underwriters showing their names, addresses and descriptions and the amount sub-underwritten by each If any of the information disclosed were considered unsatisfactory, permission to deal would be refused, but it is hardly necessary to add that admission to Stock Exchange dealing is so essential for a public issue that the promoters would be bound to amend their arrangements in accordance with the wishes of the Stock Exchange authorities Strict conditions are also attached to the permission to deal in shares originally placed privately and later " introduced " on to the Stock Exchange In 1932 a further rule was made giving the Committee power to suspend dealings in the event of serious default by underwriters or sub-underwriters The Stock Exchange has evidently stepped in where the Legislature preferred not to tread and in a most effective manner used its great power to curb the activities of unscrupulous promoters and issuing agents

(50) Of all the parties concerned in an issue, the bank which collects the applications is probably the most innocent The question has often been raised whether the bank should not make a somewhat closer scrutiny of important details of the issue and by attaching stricter conditions to the placing of its name upon the prospectus increase the value of its moral support In particular, it has been suggested that the Main Underwriting Agree-

ment should provide for the approval of sub-underwriters, not by the company's directors, but by its bankers, presumably because the latter would be in a better position than the directors to make any necessary inquiries There seems no reason, however, if the directors take their duty in this connection seriously, why they should not be able to satisfy themselves as to the soundness of sub-underwriters by themselves putting such inquiries through their bank The emphasis should rather be laid upon the main underwriter who should of course (and usually does) guarantee the fulfilment of sub-underwriting contracts

(51) These may appear to be matters of relatively unimportant detail with no bearing upon the attitude of the banker , but it must be remembered that the banker though not intimately connected with the capital market, may be considerably affected by its operations The possibility, for instance, of another "Hatry affair" can scarcely be tolerated The rules of the Stock Exchange may close certain discovered channels for the waste of capital, but the ingenuity of unscrupulous promoters is apparently unlimited, and there is no certainty that they would not be equal to opening up fresh channels in the event of a big revival in new issues There is no doubt that the consequent losses would have repercussions upon the banking system

(52) There is only one remedy for an absence of co-ordination, and that is some form of "planning"—to use a word that has now a special piquancy not always relished by the practical man It is unfortunate that this word, like many others which have had their day, is becoming the sport of political controversy , for the idea of "planning" is by itself quite inoffensive It is about particular applications of the idea that objections arise Any successful business of importance must plan its internal organisation and its external relations with definite

ends in view The planning of its relations with other allied concerns may be carried to such lengths that an entire trade or industry is brought into a more or less coherent organisation even international in its scope Amalgamations working agreements, rationalisation schemes, cartels and international agreements between producers afford endless examples of planning at every level of the economic system, showing a tendency towards ever-increasing association and ever-increasing complexity It is a healthy process which has its parallel in natural law and there is abundant evidence of the ill-effects which flow from attempts to impose artificial restraints upon this evolutionary development of the economic order But it is an essential condition of such development that it must proceed from *within* the organism An artificial stimulus like artificial restraint usually produces unforeseen and harmful after-effects This is the true objection to the 'planning" which is imposed from above It does not, however, invalidate any and every proposal for reform it only implies that in economic matters any necessary reforms are best made from within the system in plainer terms, it means "a minimum of government interference' It was not the least merit of the Macmillan Report that most of its recommendations were addressed to those actually responsible for the control and operation of the banking, currency and financial systems and not to the Government The principle observed throughout the Report is that every department is on the whole best left in the hands of those accustomed to running it

(53) This is not to say, of course, that some degree of government planning of the financial system may not be imminent The possibility in the near future of a government of the left cannot be overlooked by the banker A government if it dares can do very much what it likes

with the financial system over a short period, and politicians in general are nowadays prepared for almost any degree of government control over the nation's economic life, if the motive of such action can somehow be expressed in the familiar terms of party doctrine The only difference between left and right in this respect appears to be of degree It is therefore by no means improbable that the domestic capital market will come under some sort of government control within the next few years, though this is more likely to happen under a government of the left than of the right, as part of a socialist scheme for the reorganisation of industry It is not many years since Mr G D H Cole, in *The Next Ten Years in British Social and Economic Policy*, advocated the establishment of a Board of National Investment as a method of directing the capital resources of the country into channels which would yield the greatest social benefit The idea was not then new, it is frequently being revived, there is, indeed, a distinct possibility that within the next few years an attempt will be made to give it some practical shape The motive of the idea is public-spirited, and the Macmillan Committee rightly urged that "it is all-important to the community that its savings should be invested in the most fruitful and generally useful enterprises offering at home" (para 386), but recommended that this object be sought by a development *within* the existing financial system There is little doubt that the first method (organising from above) might have bad after-effects in the dislocation of industry, while the second method (organising from within) might lead naturally to a closer co-operation of finance and industry through the gradual reform of the domestic capital market

(54) If the banker is of the opinion that some change of the methods of home investment is desirable it is suggested that there are two alternative attitudes to be

adopted towards the subject There is the attitude that the remedy does not lie with the banks, that the capital market is outside the sphere of sound banking in this country and that any organised participation by the joint stock banks in industrial financing might positively endanger their position by causing adverse reaction in public confidence and goodwill if the banking system were assailed by the difficulties of another industrial depression This may be called the "negative" attitude in which the banker faces the two possibilities (*a*) of another investment boom possibly succeeded by another financial crisis, (*b*) of some form of government control over investment in industry, regarding such contingencies with less apprehension than he does the liabilities attaching to a more intimate association with industry The alternative attitude, which may be called "positive" can be stated thus —

(55) The weaknesses in the present structure of the domestic capital market appear to be traceable mainly to the character of the existing issuing agents and it is clear that any decisive action taken for the improvement of the market must be directed towards the establishment of issuing institutions exercising much wider functions than hitherto and acknowledging greater public responsibility Such institutions, moreover, should be designed to form an integral part of our financial system as a whole, working in close touch with the banking system and through it, maintaining contact with the wider realm of international finance In these respects the joint stock bank themselves, with their widely flung branch system, their immense resources, their unassailable reputation, their world-wide connections, and (not least in importance) a habit, now well established, of co-operation with each other in their mutual interest, possess many advantages essential to the ideal issuing institution But

a deposit bank, with the responsibilities of its immense short-term liabilities, is for this reason alone precluded from a direct entry into the long-term capital market It may, however, be possible for the bank to enter this field indirectly, in such a way as would completely segregate its investment business from its principal existing functions in the short-term credit system This segregation of functions could be achieved either by the formation of one or more subsidiary investment companies under its sole control, or by co-operation with other banks, either joint stock banks or the leading private bankers, in the establishment of associated companies, this latter course being the one suggested by the Macmillan Committee (para 403 of the Report)

(56) The former ("negative") attitude obviously leads the practical banker nowhere In fact he prefers to stay where he is This inquiry can, however, only proceed further on the assumption that the banker—with a sufficiently large number of his colleagues—has adopted the "positive" attitude which has just been adumbrated and is now contemplating its practical implications The choice between one attitude and another, between one policy and another, does not, indeed, lie with the theorist of banking, who, when he travels, as he sometimes must, beyond the safe confines of criticism to the imagination of a policy must proceed largely by faith in a hypothetical bank or banker, while treading the dangerous ground as warily as possible Without further apology, then, the writer will consider very broadly, in the final stage of this inquiry, tentative proposals for the participation by the joint stock banks in the market for supplying long-period capital to British industry

V

The New Banking?

(57) Until the financial events of 1929-1931 provided incontrovertible proof of the great strength of the British banking system and for a time effectually disarmed its less understanding critics, it had been fashionable for some years to compare the methods of British banking, particularly in its relations with industry, unfavourably with those of (usually) German banking, on the ground that, while the former favoured the commercial community at the expense of industry by restricting loan policy to short-term advances against security, the German banks made it their special business to promote German industrial development by taking an active part in the provision of long-period capital Such criticism is unimportant, since it is based upon dangerous half-truths but it is typical of a common method of approach to the problems of industrial finance in this country which is apt to be very misleading

(58) Reference has already been made (para 4) to economic conditions which were peculiar to the early growth of English industry This and other wide differences of historical origin largely vitiate the criticisms of our banking system which are based upon superficial comparisons with for instance, the credit-banks of Germany or, indeed, with the banks of any other country There is much of practical value for the English banker to be gained from a thorough comparative study of different banking systems, but it is unlikely that the results would have much bearing upon the fundamental principles of English banking This is particularly true of the

relationship between the banks and the capital market in different countries Superficial comparisons are especially dangerous here, for the character of that relationship is fundamental to each financial system and cannot be studied apart from the system as a whole

(59) Every financial system has its general problem of the capital market, which is to supply a stock of money and facilitate the transfer of capital by methods which shall ensure the direction of capital towards the points of highest net yield, but such a general statement as this has very little practical meaning by itself The same problem has presented itself in one way in England, in a different way in Germany, and again in a different way in America In each case the solution must be conditioned by a different set of social and economic circumstances and a different legal system This is to say that even the ideal solution (if there is one) must vary with the particular conditions of each country, and, it must be added, may vary in the same country at different times

(60) The conclusions of this discussion and the possibilities of future development which are suggested do not, therefore, apply to some ideal composite system containing all the best features of English and foreign practice They are intended to apply to that actual system which is centred in the City of London References must nevertheless be made to banking methods in the two countries, Germany and America, where an advanced banking system is—or has been—very closely allied with industry through the capital market At the end of this essay will be found a list of reference works from which the necessary information has been drawn

(61) In an earlier paragraph, it has been said that the banker is willing to institute any new service which can be operated within the already wide limits of the system

Some of the services already given by a bank are now so thoroughly established as to be an indispensable part of the bank's business The purchase and sale of securities on behalf of customers the safe custody of securities and valuables, the collection of coupons and dividends and all the related business of the security department, the provision of travellers' cheques and letters of credit—these are part of the well established daily practice of every moderate-size branch of every joint stock bank They can, however hardly be included among the essential functions of a bank, though there is little doubt that on the whole they contribute a not inconsiderable part of its profits Many other useful services which need not be enumerated are undertaken by the bank for the sake of the goodwill which they help to promote between the bank and its customers This class of service may involve considerable expense to the bank but, on the other hand, may make connections which will eventually be valuable There are, of course, limits to the extent to which the bank can indulge in this kind of speculation, yet once it has committed itself to an intrinsically unprofitable service, subsequent withdrawal of that facility—which customers may have learnt to regard as a right—may be practically impossible Under the present regime of cheap money, it is, however, natural and desirable that the bank should try to review its expenses upon unremunerative services, and at the same time look out for new services of a more profitable character *Among* the latter may be mentioned two subsidiary departments which in recent years have grown to some importance they are the income-tax department and the trustee department In both cases the bank is in a peculiarly fortunate position, in that it is in close and continuous contact with the financial affairs of its customers who, for their part, rarely hesitate to give the bank *their full* confidence, knowing that its officials are pledged to a secrecy which in practice is strictly

and honourably observed The pre-eminent fitness of the bank to undertake trusteeships and executorships is now well recognised, and there is evidence which suggests that this department is attaining first-class importance

(62) The foregoing considerations perhaps tend to suggest that the subsidiary functions of the joint stock bank may gain in importance in the future, under the stimuli of low money rates, a healthy competition and (one may perhaps be permitted to hope) a prudent revival of the *entrepreneur* spirit in banking It does not seem possible that bankers can willingly turn their backs upon any opportunity for profitable development which is not inconsistent with the indisputable requirements of sound English banking The following brief suggestions have been framed on the hypothesis that such an opportunity exists in the domestic capital market, which provides a practically new field for the joint stock banks which it may nevertheless be found practicable for them to enter, under safeguards which appear feasible, with benefit to their own interests as well as those of British industry

VI

The Constitution of the Subsidiary

(63) In paragraph 35 it was noted that the Macmillan Report recommended that the joint stock banks should co-operate to form one or more issuing institutions somewhat on the lines of the Bankers Industrial Development Company The writer would not favour this course simply for the reason that a concern which is, so to speak everybody's business, may soon end by being nobody's business The Bankers Industrial Development Company may have done much useful work behind the scenes but according to Mr Finnie, " so far as the public know, it has been actively concerned in three schemes, and these have been rationalisation schemes No indication has been given that it intends to enter the issuing market in any other way "* The company was formed in April 1930 under the virtual control of the Bank of England, though practically all the joint stock banks and issuing houses of importance participated in the capital of the company, which was nominally £6 millions It thus embodied an unprecedented amount of " co-operation " by the banks, but for various reasons it does not appear that this company could serve as a model for our present purpose

(64) There does not seem to be any reason to assume that each bank could not take singly that action which the Macmillan Report proposed they should take together There is no obvious difficulty in the way of each bank forming its own subsidiary company in fact, once the bank decides to take the first step, it would probably be much easier for it to proceed to solve the more " mechani-

* *Capital Underwriting* (David Finnie), p 198

cal " problems of form and organisation on its own lines, in ways most suited to its individual constitution No positive reason was advanced in the Macmillan Report for the co-operative type of undertaking , and it is believed that the balance of advantage can be shown to be on the side of individual action It is likely that any decisive action would be unnecessarily delayed, both in the early formative stages and in subsequent operations, by the rigid and unwieldy type of organisation which must result if all the banks were to join together in a permanent joint stock company The formation of such a company might require endless negotiation and, once formed, it would lack the incentive to success which springs from loyalty to a single parent institution It would be correspondingly difficult for the bank to feel much pride in, or claim any credit for, an offspring in which it had only a minor share

(65) It may be argued in support of the " permanent co-operative " scheme that (*a*) it would enormously reduce the risk of loss to any one bank , (*b*) it would enable the company to start with a much larger capital than any one bank would care to invest in a subsidiary , (*c*) it would inspire greater confidence among the public , (*d*) it would remove the possibility of competition in a field where competition might be dangerous , (*e*) it would absolve the individual bank from special blame in the event of one of the company's issues meeting afterwards with misfortune

(66) The following considerations may be opposed to these arguments (*a*) The risk of loss would certainly have to be spread in certain large transactions, but such provision could be made equally well by a group, on the lines of the German *Konsortium* or American *Underwriting Group* of banks or investment banks bound together by a temporary arrangement for the purpose of a single capital issue, the group being liquidated after a

certain specified period (*b*) An immense capital might look very impressive (this is not in itself an unimportant consideration), but would probably be unnecessary for the ordinary operations of the company, and would at once make it very difficult for the company to earn reasonable dividends The issuing of securities need not of itself involve the locking up of very large sums for any considerable length of time, while such direct accommodation as did become necessary might for short periods, be financed by bank loans, or, for longer periods, by the issue of the company's own short-term notes (see para 34 Recommendations of the Macmillan Committee) These and similar measures appear to be quite within the reach of a company of the subsidiary type with a moderate capital of from one to two millions (*c*) The question of public confidence in an issuing company is one of great importance It has already been suggested that investors might be protected to a greater extent than they are at present if they could be taught to look for the name of a responsible issuing institution when scanning a prospectus or other invitation to subscribe capital This would mean a change of habit which it might take some time to bring about and which would depend very much on the cumulative effect upon the public mind of some years' experience of a new regime in the domestic capital market The field is so wide that there is ample room for several first-class issuing companies, and this fact alone seems to point towards the desirability of a number of compact and manageable companies, acting in combination whenever necessary In the long run, of course, the prestige of each would depend upon the ability with which it was managed (*d*) The dangers of competition, given the prudent management which it would be reasonable to expect from English bankers are probably insignificant A certain degree of competition would probably result from a healthy activity, and vice versa It is extremely

unlikely that English bankeıs, even in a period of great investment activity, would run riot in the new-issue market as American bankers certainly did in 1928 and 1929 In fact, this is one of several respects in which an almost morbid dwelling upon the unfortunate experiences of foreign countries may raise in us absurdly disproportionate fears and excessive scruples as to the possible results of perfectly justifiable experiments in this country That is why it has been suggested that although a study of foreign banking systems has its uses, it also has its pitfalls A system which is in itself good or at least harmless in most respects may become hopelessly discredited through defects, not of its intıinsic logic, but of personal ability, honesty or prudence in a few of its administrators (*e*) On the other hand, the possibility that some blame might fall upon the issuing company if any of the securities which it had issued eventually came to grief cannot be lightly dismissed, and it seems likely that the bank subsidiary acting on its own would be more vulnerable in this respect The ultimate safeguard, irrespective of the protection afforded by the consortium arrangement, must lie in the fullest investigation of every proposition before it is made public, followed by a continuous watch over the security This admittedly onerous obligation is not too heavy a price to pay for public confidence and goodwill, though it would certainly involve the issuing company, or its parent bank, in the maintenance of a costly economic advisory and research department

(67) The foregoing arguments obviously raise questions of faı-reaching importance, some of which will have to be slightly enlaıged upon in later paragraphs In so far as such questions concern matters of administrative and technical detail, they cannot be dealt with in this very bıoad outline of the main possibilities of a further extension of the functions of a joint stock bank in the capital

market It has been suggested, it is hoped without undue bias, that the bank, since it obviously could not enter that field itself, should do so by means of forming a subsidiary company in preference to co-operating in the formation of a more or less independent company in which most, or all, of the other joint stock banks, to say nothing of the big private banks would participate It is suggested that this subsidiary, which for the sake of convenience will now be called ' the Company," should be registered as a private limited company, the bank controlling all the share capital which should be not less than one million and not more than two million pounds

VII

The Operations of the Company, its Organisation and Personnel

(68) It is clear that the Company, once formed, cannot possibly commence full-scale operations forthwith. It is only necessary to bear in mind the economic position of the Company, midway between the industrial system and the sources of new capital. The basis of the Company's operations must be the gradual building-up of its co-ordinating and intelligence departments, and this process would probably take several years to reach a really satisfactory stage. For this reason it would perhaps be advisable for the preliminary stages of the Company's career to be accomplished without the unhelpful influence of immoderate publicity. There is a tendency nowadays for innocent critics of our banking system to regard the participation of the banks in industrial finance as being almost in the nature of a panacea for the industrial situation, and there is a distinct danger that if the Company's formation were staged with too much publicity the exaggerated hopes which would be aroused might suffer an early disappointment which would react unfortunately upon public goodwill. It may well be advisable for the banks to show a broad vision and a wise courage in formulating some such schemes as are here adumbrated, but it would be equally desirable that they should not try to realise any large pretensions in the experimental period.

(69) The foundation of successful working in the capital market must be an expert personnel and an accumulated fund of knowledge and experience. To this end, while the administration of the Company would, doubtless, be

drawn from the parent bank it would hardly be advisable for the executive officers and the staff to be drawn exclusively from the same source The members of an economic intelligence department, for instance should unquestionably be men possessing the special qualifications necessary for the investigation of all proposals submitted to the Company The ability to cope with statistical material to reduce such data to an intelligible form from which reliable conclusions may be drawn, depends primarily upon advanced training and secondly upon practical experience The personnel of the Company should include qualified accountants, familiar with industrial business, and a solicitors' department possessing wide experience in company and city practice No doubt the Company would be obliged for a time to secure the assistance of independent experts, until it built up a thoroughly competent staff of its own, but it should almost certainly be the policy of the Company to make itself as independent as possible of outside consultants, except when dealing with exceptional problems Only in this way could the Company acquire that body of co-ordinated knowledge and accumulated experience essential to a sound policy

(70) The Company would probably find it necessary in addition to its city headquarters to have branches in two or three of the most important industrial centres The number of such branches could be increased as the Company's business expanded, their purpose being the maintenance of friendly relations with important industrial customers of the parent bank Through these branches the Company could collect information and, if necessary, collaborate with the local branches of the bank in advising customers on financial matters By this means valuable business might be secured by the Company In any case, it should always work in collaboration with the bank, to their mutual advantage, and it should not be difficult,

given the integrity of purpose which characterises English banking, to disabuse public opinion of any suspicion, for instance, that the bank was unfairly using its subsidiary to secure the repayment of its frozen advances by obtaining new capital from the public on behalf of its embarrassed debtors This and other kindred aspersions, if they did ever arise, could easily be met by the Company's publishing at regular intervals—say, quarterly—as frank and full an account of its operations as might be possible

(71) The highest officials of the Company should from time to time make a tour of the bank's important industrial customers It would probably be found that, with the friendly assistance of the bank's branch managers, such visits would come to be looked upon by customers as providing opportunities for useful consultation

(72) The Company's economic research department should be at the disposal of every customer of the bank, though a charge would have to be made for its services Research, in the financial as in every other field, is notoriously costly, as the experience of American banks has shown , though there the statistical department is said to be considered valuable for the goodwill it creates There is, however, good reason why the research department should be regarded, not as an expensive luxury, but as the very core of the Company's activities

(73) The main operations of the Company would no doubt include all those functions which are summarised in paragraph 399 of the Macmillan Report Their technical nature, however, prohibits any speculation on the innumerable detailed considerations which would only emerge in practice Broadly speaking, it can be said that the principal function of the Company would be the issuing of securities to the public, and in this connection we may perhaps venture upon the following considerations

(74) The two methods of issuing securities, (i) by inviting public subscription, (ii) by purchasing an entire issue and later "introducing" the shares or stock on the Stock Exchange, might both be followed, the latter method being probably more applicable to comparatively small issues

(75) This is the point at which a brief reference to the systems operating in the United States of America and Germany may be appropriate In America, the usual procedure is for the "originating' firm (or investment bank) to contract for the purchase outright of an entire issue of stock or bonds It may then form an "underwriting group" of, say, eight of the strongest investment banks with which it is in friendly relations The next step is probably the formation of a "banking group" consisting of, say, seventy or eighty investment banks spread over the entire country Finally a "selling group," running perhaps into several hundreds, is arranged *by the originating* house, and it is the selling group which has to dispose of the securities to the public The complete organisation is managed by the originating house which fixes the price at which the security is to be offered to the public the form and date of the advertisement, the date of issue—which is, of course, the same throughout the country—the selling commission and the proportion of this commission which *may* be allowed by members of the selling group to recognised *dealers*, banks, brokers *or* insurance companies The *price of the* security increases by small additions as it issues from the originating house and passes from group to group, the selling group finally paying the same price as the public and being remunerated by a commission of, say, two per cent, payable as soon as possible after the closing of the accounts between the groups The life of the groups may be fixed at two months, or may be extended if necessary The managers reserve to themselves the right not only to fix the terms of

the issue but also to take any necessary steps, in association with the banking group, to support the security in the market in various ways which need not be discussed here It is hardly necessary to remind the reader that there are many variations of detail in the organisation and carrying through of a large public issue , but, up to the crisis which at length produced the restrictive legislation of 1933 and onwards, American methods seemed to be settling into fairly definite lines chairs in Investment Banking were, indeed, founded in the universities and the subject came in a remarkably short time to be regarded as a " science," to which much painstaking research and several heavy volumes were devoted It was not until 1928 that the idea of active participation in the capital market by means of subsidiary companies spread really rapidly among the commercial banks of America In 1929 nearly every large urban commercial bank had one or several such subsidiaries, " wholesale " or " retail," with an army of salesmen The Banking Act of 1933, expressing the furious determination of the American people to clean up the banks, ruthlessly suppressed all the investment side of their activities An imposing structure was instantly—and, it may one day be thought, too rashly—demolished

(76) For an analysis of that structure, its strength and its weakness, the reader might well turn to Dr R W Goldschmidt's *The Changing Structure of American Banking* The impression left on his mind by that critical account will probably be that the organisation of the cap tal market and the temper and tradition of banking in America are so widely different from English ideas and institutions as to be almost meaningless for us as either an example or a warning But in at least one respect an English bank facing the difficulties inherent in any more active participation in the domestic capital market might,

it is respectfully suggested learn something from America. There the highest importance has been attached to accurate statistical research into conditions in industry and in individual companies. As the Macmillan Report reminded us, "A really big American bank, for instance, would have a large department engaged in studying particular industries and the companies engaged in it, in keeping a close touch with developments and in being ready to provide any information required." In fact research departments, generally regarded in this country as an ideal, perhaps of questionable commercial value and certainly very expensive, have for some years been recognised as an indispensable adjunct of American banking and investment. There need be no doubt that industry and the investor have benefited by this accumulated fund of expert knowledge of financial and industrial conditions at the disposal of the banks.

(77) In Germany, again, the relations between finance and industry have differed widely from those which are traditional in England. Company promotion has always been one of the most important functions of the great German joint stock banks, especially during the last century when they were most active in this direction. The extraordinarily rapid rise of German industry and foreign trade would have been an impossibility without the financial assistance of the joint stock banks, for Germany was far from being a wealthy country. Privately owned capital was scarce and in their early career the banks were often obliged to lock up part of their own capital for extended periods. Permanent participation in industrial concerns, however, has never willingly been the policy of the German banks: their function in the capital market has generally been that of middlemen, though very active and enterprising middlemen. As they grew in importance so their functions became more

varied, including such as in this country are performed by specialised agents like company promoters, issuing houses, underwriters, discounting and acceptance houses and stockbrokers The banks also, of course, undertook all the ordinary business, as we know it, of a deposit bank , and as their deposits grew and the financial organisation of the country developed to maturity, their " promoting " function began to take a more subordinate place The majority of important capital issues are still, however, made by or with the assistance of the banks, acting singly or, for the largest issues, in *Konsortien* which are in many ways similar to the American " groups " But the important feature, requiring immediate emphasis, of the relationship between the German joint stock banks and the capital market is that it is *direct* unlike the American commercial banks which established subsidiary or sub-subsidiary Securities Companies for the purpose, the German banks combined in themselves the functions of an issuing house and of a deposit bank That they were able to do so was due, partly, to the absence of prohibitive laws, but mainly to the possession of capital resources of their own much larger in proportion to their banking liabilities than we find in English banking at the present time It should be added that, where there has been a risk in locking up an excessive proportion of their own resources, the banks have sometimes avoided it by contributing to the formation of special financial companies in collaboration with the industrialists

(78) The taking up of entire capital issues—the common practice of the issuing agent alike in Germany and America—clearly requires a capital far in excess of anything which could find continuous remunerative employment in this country but we have suggested that the typical English method of raising capital by inviting public subscription to a new security renders a very large capital

unnecessary for the ordinary operations of an issuing house On the other hand, there might be a considerable saving of the " preliminary expenses, usually disproportionately large on smaller issues if these could be purchased outright in the first place by the Company and subsequently offered to the public through the Stock Exchange The method is somewhat speculative and from the investor's point of view appears at present to be open to the objection that, in purchasing such a security immediately dealing is permitted, neither he nor the Stock Exchange dealer can always be certain that its opening price is truly representative of its market value In Germany, according to Mr P Barrett Whale the Bourse authorities must be informed beforehand of the price at which " introduced " shares are to be first offered, and it seems likely that some similar ruling by the London Stock Exchange is desirable for the protection of the ordinary investor from abuses of this otherwise admirable method of making an issue of small or moderate size Where, however, the intermediary instead of being possibly an irresponsible syndicate or obscure company was a first-class issuing institution (or group of similar institutions) of the kind we have endeavoured to outline the investor would have all the assurance he needed that the " introduced ' security had been subjected to the same exhaustive examination as any security issued by the Company through public prospectus (a safeguard especially valuable when applied to new enterprises) It would probably be a useful reform if the Company could state in its advertisement the price at which it intended to offer the security for sale It could then cover itself against the possibility of loss by the formation of an underwriting group to last for a period judged sufficient to enable the market to absorb the whole of the issue

(79) Probably, however, the majority of the Company's

issues would be made by prospectus, this method avoiding the considerable risk which the Company might run in locking up its own resources in a large issue , and being, moreover, more suited in this country to the making of that wide public appeal which is usually essential for a good market in the security

(80) While the Company must be able to look to its parent bank for the temporary advances which might from time to time be necessary to enable it to provide accommodation in anticipation of an issue, the bank's liability in this respect should be clearly laid down To obviate any public misgiving on this score the amount of any advances to the subsidiary could be disclosed in the published accounts of the bank There is, of course, no reason why the Company should not allot a moderate proportion of its own resources to such an object as the financing of long contracts by British companies This is a development of our financial system on the need for which the Macmillan Report laid great stress (para 396)

(81) As between new or established enterprises, the Company need not have any inelastic principles Every proposal put before the Company, coming from whatever source, would have to be debated on its own merits , but it is precisely in connection with new enterprises that the Company's authority would be of the greatest benefit to the public

(82) The hazards and rewards of new enterprise assume a somewhat different complexion as ownership and control in industry become more completely separated Neither the investor who only invests, without seeking any further responsibility for the direction of the concern, nor the *entrepreneur* who ventures mainly other people's money seems to be morally deserving of the same reward that might fairly have been claimed in the old days by the

entrepreneur who ventured mainly his own capital On the other hand, if the investor is bound, by the nature of modern capitalism, to be deprived of any but the most remote and indirect control of the concern of which he may as shareholder be the part owner, he is perhaps entitled, as compensation for that loss of personal control, to the assurance of some supervision of the concern by a powerful, interested body, with interests more or less the same as his own In the case of established securities he may reap the benefit of such supervision as is exercised by the investment trusts, insurance companies bondholders' and shareholders' associations and so on, but in the case of new industrial securities we have suggested that the only protection of much value to the average investor would be that afforded by the preliminary investigation made by the research department of an issuing house with an acknowledged reputation So much for the argument from the point of view of the average investor From the Company's point of view, it may simply be said that the Company would be closing the door on an important avenue of remunerative public service if it fought shy of new enterprises, though admittedly, they would make thorough investigation and sound judgment on the part of the Company all the more essential

(83) Finally, we may suggest that all the operations of the Company must be largely governed by the ordinary practice of the City and by the consequent necessity for co-operation, and the maintenance of friendly relations, with all the important institutions of the City, perhaps above all with the central bank From the social point of view it is obviously desirable that the nation's savings should be put to the most productive uses and if this clear necessity does not point towards State control of the capital market, the alternative solution can only

lie in the growth of some degree of self government within the market This may sound a tall order to the practical man, be he banker or broker, who happens to find himself involved in a responsible way in industrial finance as at present conducted It is a condition which, we have concluded, can be met only by an elastic co-ordination of issuing institutions acknowledging their public responsibility A similar state of affairs has long existed in the short-term market—an example which might well supply the inspiration a practical man usually needs before he will consent to a change in his business habits But it is important to remember that co-ordination in the short-term system has always been accompanied by *control* by the Bank of England It therefore seems likely that the complete rationalisation of home investment would likewise depend upon the consent of the Bank to act as a kind of general overseer of industrial issues In normal times the Bank has exercised a general power of supervision over the issue of foreign loans in London, owing to its close relations with the merchant-banking houses which conducted such issues Unless, therefore, the Treasury (or some new State department) is to assume in the future the same power of veto in the entire domestic capital market as it exercises at present over municipal and foreign investment, it seems that the proper repository of such authority would be the Bank of England In this way, moreover, the relations between the market and the credit system would be considerably strengthened at the centre Much, therefore, might depend upon the attitude of the Bank of England towards some such development of the banking system as has been outlined here Any conjecture on the point would be dangerous, yet there does not appear at present to be any evidence to suggest that this attitude would be other than friendly

VIII

Conclusion

(84) The nature of our present discontents is so varied that most economists despair of ever finding any comprehensive and workable plan for that general recovery for which our nation has been sighing so long Bankers however are not economists in the professional sense of that word It is sometimes said to be a source of strength in men of action that they are not always acutely aware of all the dangers waiting round the corner It is perhaps open to argument whether the banker should be considered a man of action , but if the sole test of acute awareness of danger were applied, the result would probably appear to some of his critics to show that he is not His apologists at least equally numerous would say that the banker's main business is to look after other people's money, and that in view of this tremendous trust he is justified in guarding against every imaginable risk including those which actually exist and others which may not However this may be, a body of responsible opinion is looking to the great joint stock banks of the country to give a lead in one of the urgent problems of the day which is to secure the most effectual organisation of the capital market for the benefit of British industry A very great deal, perhaps more than is generally realised may depend upon the banker's attitude to this problem and the extent to which he is able to contribute towards its solution

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